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SUBJECT: Overall Inflation Climbs Again in Third Quarter

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¶1. After falling in the second quarter from the drought-induced March peak thanks to a good rainy season, overall inflation began climbing again in August. Since September 2005, food prices have risen 20%, which impacts the poor most heavily. Interest rates began rising in August. The Central Bank of Kenya (CBK) predicted that overall inflation would continue to rise in the next two months due to dry weather and high oil prices. However, the CBK raised its Central Bank Rate (CBR) 0.25% on August 2 and increased sales of securities to soak up excess liquidity to keep underlying (core) inflation within its 5% target level. Underlying inflation, which excludes food, energy and transportation, also began increasing in August, but remains about 4%. It appears the CBK will be able to keep monetary growth and inflation under control in 2006, and forecasters continue to predict economic growth over 5% in 2006.

#### How the GOK Measures Inflation

¶2. On a monthly basis, the Central Bureau of Statistics (CBS) releases Consumer Price Indices (CPI) and inflation rates for Nairobi and 12 other urban centers, and for lower and upper income groups in Nairobi. The "overall" (headline) inflation rate is based on prices for 10 categories of goods and services. The CBS measures "underlying" (core) inflation by removing the volatile categories of food and energy, but the CBK also removes transportation, since it relies so heavily on energy prices. The CBK targets its underlying rate in its monetary policy planning and implementation.

¶3. The titles the CBS, CBK and media use for the time series inflation measures are misleading and inconsistent. Here are the translations.

Month-on-Month or 12-month: Actually year-on-year (YOY) change in prices, since it compares the CPI in the current month with the CPI in same month in the previous year.

Average Annual: Compares average CPI for the last 12 months with the average CPI of the preceding 12 months. This measure serves as the seasonally-adjusted inflation rate, and is less volatile.

#### Overall Inflation Rates Fall in Q2 with the Rains...

¶4. Overall inflation climbed into the double digits in January 2006, when failure of the October 2005 rains created or perpetuated drought in many parts of Kenya, driving up food prices. When the next rainy season began on schedule in March, food price increases, especially in the basket of basic vegetables that form the basic diet for lower income people, decelerated or declined, and the CPI began falling. In March 2006, YOY overall inflation peaked at 19.15% and average annual (seasonally adjusted) peaked at 11.36%, the highest rates in more than two years. April-July, both rates

declined steadily, as food, energy and transportation inflation decelerated. The CBK welcomed the declining CPI and predicted it would continue.

But Increase Again in August.

15. In August, food and fuel prices accelerated again, driving the CPI and overall inflation up. The distribution of rains across the March-May rainy season had been uneven, reducing vegetable production on rain-fed farms, causing markets to rely on irrigated farms, with their higher prices. Higher fuel prices and inefficiencies in production, transportation and marketing also drove prices up. YOY overall inflation rose 11.5% in August and 13.8% in September. Average annual jumped from 11.4% in August to 12.1% in September, the highest rate observed so far in 2006. The CBS noted that food prices in September 2006 rose 20% YOY, followed by energy prices at 11.9%, alcohol and tobacco at 9.2%, transportation and communication at 8.5%, and housing at 3.7%. The other five categories rose 2%-3%. Although it had predicted in early August that food prices would stabilize and inflation would continue to fall, by early September the CBK acknowledged that food prices and inflation were once again on the rise. In its October 6 weekly report, the CBK predicted that overall inflation would continue to rise in October and November due to dry weather and high international oil prices.

16. The price increases hit the low income group in Nairobi hardest, since CBS weights food expenditure at 56% of their expenditure. CBS weights food expenditure in the other urban centers at 50%. Facing such weights and such high inflation, econoff asked analysts from CBS, CBK and other agencies how the over half the population allegedly living on \$1/day avoided starvation. The analysts acknowledged the CPI survey did not cover rural areas, where the majority of the population resides, nor the food that urban residents receive from their families' farms. They also guessed that uncounted remittances from Kenyans abroad (estimated by the Economist Intelligence Unit (EIU) at about \$685 million in 2006) helped many Kenyans survive price increases. They were eagerly waiting for the results of the nation-wide, district level household survey CBS completed at the end of May to help them refine their analyses and produce a clearer, more comprehensive picture.

17. In addition to the rising prices of goods and services, the CBK was also facing other inflationary pressures. Confronted with unexpected growth in the money supply and high liquidity levels due to strong dollar inflows from remittances, plus a strong growth outlook for 2006, the CBK raised the Central Bank Rate (CBR) from 9.75% to 10% on August 2. Over the next two months, the CBK also increased its purchases of repurchase agreement securities (repos) to soak up excess liquidity. In response, interest rates on GOK T-bills, repos and interbank loans all rose. T-bill rates have been rising for the last nine weeks. In the October 5 auction, the 91-days Treasury bill rate increased by 12 basis points to 6.79 percent, while the average 182-day Treasury bill rate increased by 26 basis points to 8.25 percent. In early October, the CBK decided to maintain the CBR at 10% because underlying inflation remained under control.

Underlying Inflation Rises More Slowly

18. The CBK's underlying inflation rate, which excludes food, energy, and transport and communications because of their volatility, fell from a peak of 4.9% YOY in December 2005 to 3.6% YOY in July. In August, underlying inflation rose to 3.9% YOY, and then to 4% in September. However, average annual underlying inflation (seasonally adjusted) has been declining steadily in 2006, falling from 5.4% in December 2005 to 4% in September 2006. The CBK therefore reports it has inflation under control.

Comment

19. Kenya's government and private sector analysts agree the GOK needs to improve their understanding of Kenyan household income and spending patterns in different geographic and income sectors, and more finely tune its price collection and analysis techniques to provide more effective information to guide monetary and fiscal policies. One could argue that CBK, by narrowing its definition of core inflation, has set itself too easy a target for controlling

inflation. If the October-December rains are adequate and evenly distributed, both geographically and temporally, food prices and inflation will likely begin to fall before the end of 2006. Or not.

The GOK has announced other policies that could also, over the longer run, reduce costs for producers, like improvements in transportation, power and telecomm infrastructure, or increase efficiencies in the food marketing chain.

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